The Florida Senate

BILL ANALYSIS AND FISCAL IMPACT STATEMENT

(This document is based on the provisions contained in the legislation as of the latest date listed below.)

Prepared By: The Professional Staff of the Banking and Insurance Committee

BILL: CS/SB 1460

INTRODUCER: Banking and Insurance Committee and Senator Richter

SUBJECT: Contract Year for the Florida Hurricane Catastrophe Fund

DATE: February 16, 2010 REVISED:

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Emrich	Burgess	BI	**Fav/CS**
2.				
3.				
4.				
5.				
6.				

Please see Section VIII. for Additional Information:

A. COMMITTEE SUBSTITUTE.....	X	Statement of Substantial Changes
B. AMENDMENTS........................		Technical amendments were recommended
		Amendments were recommended
		Significant amendments were recommended

I. Summary:

Legislation enacted in 2009 changed the contract year of the Florida Hurricane Catastrophe Fund (FHCF) from June 1st through May 31st to January 1st through December 31st (a calendar year), starting January 1, 2011.[1] To implement the contract year date change, the legislation created a "transitional" contract year for 2010, which began on June 1, 2010, and ended on December 31, 2010. The shortening of the 2010 contract year to 7 months will cause an accounting problem for insurers due to the acceleration of the recognition of an insurer's expense (of FHCF reinsurance) resulting in potential solvency difficulties for insurers.[2] In essence, an insurer's revenue will not match its expense, and the resulting loss could unduly reduce surplus, thus impacting an insurer's financial solvency.

Senate Bill 1460 corrects the "transitional" 2010 contract year problem by changing the FHCF's contract year back to June 1st through May 31st thereby eliminating the acceleration of an insurer's expenses for purchasing FHCF reinsurance. The bill provides legislative intent language which emphasizes the importance of providing residential property insurers with more

[1] Ch. 2009-87, L.O.F.
[2] See footnote 9 below for a more thorough explanation of this issue.

time to negotiate and purchase private reinsurance and a greater degree of certainty regarding the coverage provided by the FHCF. To facilitate these goals, the bill requires the FHCF's aggregate coverage and aggregate retention to be published in the Florida Administrative Weekly by January 1 of each year, the FHCF's reimbursement contract to be adopted by February 1 of each year, and insurers to execute their FHCF reimbursement contract by March 1 of each year (with an effective date of June 1). These procedures will afford insurers greater opportunity to better estimate their coverage from the fund and their private reinsurance needs. These changes will likely result in lowering reinsurance costs for insurers which could benefit consumers by lowering their premiums.

The bill also changes the retention multiple formula in calculating an insurer's retention, by using exposure from "two years" prior (as opposed to "one year" provided under current law) in calculating the retention factor. This change will permit the FHCF to calculate and provide retention multiples to insurers earlier in the year because the FHCF will no longer have to wait on its more recent exposure data. The retention formula change will enable property insurers to obtain FHCF reinsurance earlier in the year and be able to more accurately assess their need for additional private reinsurance in advance of the upcoming hurricane season.

The legislation also caps the FHCF's mandatory layer at $17 billion, unless the FHCF has capacity to pay $17 billion in one year and $17 billion in the subsequent year. This provision accomplishes the objective of making the FHCF's mandatory layer more of a certain (known) benefit for insurers.

This bill substantially amends the following section of the Florida Statutes: 215.555.

II. Present Situation:

The Florida Hurricane Catastrophe Fund (FHCF or "fund")

The FHCF is a tax-exempt fund created in 1993 after Hurricane Andrew as a form of mandatory reinsurance for residential property insurers.[3] All insurers that write residential property insurance in Florida are required to buy reimbursement coverage (reinsurance) on their residential property exposure through the FHCF. The FHCF is administered by the State Board of Administration (SBA) and is a tax-exempt source of reimbursement to property insurers for a selected percentage (45, 75, or 90 percent) of hurricane losses above the insurer's retention (deductible).[4] The FHCF provides insurers an additional source of reinsurance that is significantly less expensive than what is available in the private market, enabling insurers to generally write more residential property insurance in the state than would otherwise be written. Because of the low cost of coverage from the FHCF, the fund acts to lower residential property insurance premiums for consumers. The FHCF must charge insurers the "actuarially indicated" premium for the coverage provided, based on hurricane loss projection models found acceptable by the Florida Commission on Hurricane Loss Projection Methodology.

Insurers must first pay hurricane losses up to their "retention" for each hurricane, similar to a deductible, before being reimbursed by the FHCF coverage. The retention is adjusted annually

[3] Section 215.555, F.S.

[4] Retention is defined to mean the amount of losses below which an insurer is not entitled to reimbursement from the fund. A retention is calculated for each insurer based on its proportionate share of fund premiums.

based on the FHCF's exposure. For 2009 hurricane season, the retention was approximately $7.223 billion for all insurers combined.

For the 2009 hurricane season the FHCF provided $17.175 billion in mandatory coverage for 186 insurers. That amount is adjusted annually based on the percentage growth in fund exposure, but not to exceed the dollar growth in the cash balance of the fund. The maximum coverage amount for each insurer is based on that insurer's share of the total premiums paid to the fund.

Legislation enacted in 2007, increased the coverage limits of the FHCF for the 2007, 2008 and 2009 hurricane seasons by adding two additional layers of optional coverage that property insurers may buy: Temporary Increase in Coverage Limit Options ("TICL"), that allows residential property insurers to purchase additional reinsurance above the FHCF mandatory coverage and Temporary Emergency Additional Coverage Options ("TEACO"), that allows such insurers to purchase additional coverage below each insurer's market share of the FHCF retention.[5] In 2009, the Legislature implemented a provision to reduce the FHCF's exposure and payout by phasing out the TICL layer of coverage over a 6 year period at a rate of $2 billion a year until the TICL coverage is completely phased out in year 2014.[6] The legislation increased the price of the TICL layer by an additional multiple each year until TICL is eliminated in 6 years. The fund was also authorized to implement a "cash built up" factor which would increase the reimbursement premiums that the fund charges property insurers for the mandatory layer of coverage provided by the fund.

The fund also permits qualified "limited apportionment companies" (generally, insurers with $25 million in surplus or less), insurers that purchased this layer of coverage in 2008, and companies that qualified for the insurance capital build up incentive program, to purchase coverage from the fund that reimburses the insurer for up to $10 million in losses, for each of two hurricanes. As in past years, the coverage is priced at a 50 percent rate on line (e.g., $5 million premium for $10 million in coverage) with a free reinstatement for a second event. The insurer's minimum retention level for such coverage remains at 30 percent of the company's surplus. Similar coverage was offered to these insurers in 2006, 2007 and 2008. In 2009, the $10 million coverage option was purchased by 55 companies, for which $110.3 million in premium was collected.[7] This coverage option expires by operation of law on December 31, 2011.

Reimbursements to insurers for losses above the current cash balance of the fund will have to be financed through bonding. If a large storm triggered the full capacity of the FHCF, bond issues totaling over $19 billion could be necessary for the fund to meet its maximum obligations. Bonds would be funded by an assessment of up to 6 percent of premium on most lines of property and casualty insurance for funding losses from a single year, and up to 10 percent of premium for funding losses from multiple years. The State Board of Administration, as administrator of the

[5] Ch. 2007-1, L.O.F. The TEACO options allow an insurer to select its share of a retention level of $3 billion, $4 billion, or $5 billion, to cover 90 percent, 75 percent, or 45 percent of its losses up to the normal retention for the mandatory FHCF coverage. This coverage option expires by operation of law on May 31, 2010.
[6] Ch. 2009-87, L.O.F.
[7] Forty two insurers were approved by the Office of Insurance Regulation as limited apportionment companies; eight insurers qualified as purchasing FHCF coverage in 2008 and five companies qualified for the insurance capital build up incentive program.

FHCF, has considered options for purchasing reinsurance and risk transfer products available from the capital markets.

In 2009, the mandatory layer of FHCF coverage totaled $17.175 billion, for which insurers were charged $1.069 billion in premiums. The optional TICL coverage was purchased by 73 insurers for the 2009 hurricane season. The FHCF provided $5.497 billion in TICL coverage in return for premiums totaling approximately $273 million. For the third consecutive year the TEACO coverage was not selected by any insurers, presumably due to the cost, which is much higher than the mandatory coverage and the TICL coverage. The FHCF has a $4.5 billion cash balance (which includes $1.5 billion in premiums collected for the 2009/10 contract year), and has access to $3.5 billion in pre-event notes, providing the fund with approximately $8 billion in liquidity, plus the expectation of being able to bond approximately $11 billion.

The total liabilities of the FHCF could have been up to approximately $23 billion based on actual coverage options selected for the 2009/10 season. Losses above the fund’s liquidity level are intended to be financed through the issuance of revenue bonds. However, instability in the worldwide financial markets has greatly reduced the fund’s ability to raise money through bonding. Based on historical loss patterns, the fund’s current liquidity would enable it to timely reimburse insurers for the first 3 to 6 months after a hurricane event, before its $8 billion in liquid resources would be exhausted, but it is anticipated that the FHCF could issue $11 billion in bonds given the current financial markets over the course of a 12 month period after the event. The FHCF’s estimated $19 billion in capacity would fall short of funding the maximum statutory limit of $23 billion of coverage that was purchased for the 2009-2010 contract year. However, improvements in the financial markets could increase the fund’s bonding capacity and allow it to reach its maximum statutory limit of capacity. Federal legislation (Catastrophe Guarantee Obligation Act, see S. 886 and HR. 4014) has been filed that if passed would result in the federal government guaranteeing FHCF bonds.

In 2009, the Legislature changed the contract year of the FHCF from June 1st through May 31st to a calendar year beginning January 1st through December 31st, starting on January 1, 2011.[8] This change was done to facilitate the purchase of private reinsurance by residential property insurers. To implement the contract year date change, there is a transitional contract year for 2010, which begins on June 1, 2010, and ends on December 31, 2010.

III. Effect of Proposed Changes:

Section 1. Amends s. 215.555, F.S., pertaining to the FHCF. The bill changes the FHCF contract year to June 1st through May 31st, thus negating the change made to the contract period (January 1st through December 31st) in legislation enacted in 2009. A definition of “contract year” is provided for under s. 215.555(2)(o), F.S., to mean the period beginning on June 1st of a specified calendar year and ending on May 31st of the following calendar year.

According to representatives with the FHCF and with insurers, changing the contract year back to June 1st through May 31st was necessary to address and ameliorate accounting difficulties relating to the 2010 "transition" contract year provision (June 1, 2010 through December 31,

[8] Ch. 2009-87, L.O.F.

2010), which was enacted in 2009. The shortening of the 2010 contract year to 7 months will cause an accounting problem for insurers due to the acceleration of the recognition of an insurer's expense (of FHCF reinsurance) resulting in potential solvency difficulties for insurers. In other words, an insurer's revenue will not match its expense, and the resulting loss could unduly reduce surplus, impacting an insurer's financial solvency.[9] The proposed change to the contract year eliminates this acceleration of an insurer's expenses for purchasing FHCF reinsurance.

The bill adds a section providing legislative intent language which states that changes made to the FHCF by the Legislature during the legislative session may create uncertainties or disadvantages for insurers who participate in the FHCF when such insurers negotiate private reinsurance contracts. These problems are exacerbated by the fact that the legislative session ends approximately one month prior to the start of the FHCF contract year (June 1st) and the beginning of the hurricane season. Providing FHCF insurers with more time to negotiate procurement of private reinsurance and a greater degree of certainty regarding the coverage provided by the FHCF, will enable the residential property insurance market to operate with greater stability and more economically. In order to achieve these goals, the bill requires the State Board of Administration to publish in the Florida Administrative Weekly, the FHCF aggregate coverage and aggregate retention by January 1 of each year; to adopt the FHCF reimbursement contract by February 1 of each year, and for insurers to execute their FHCF reimbursement contracts by March 1 of each year (with an effective date of June 1). Publishing the fund's limit of coverage and total retention early enough will afford residential property insurers greater opportunity to better estimate their coverage from the fund and their private reinsurance needs. These changes will likely result in lowering reinsurance costs for insurers which could benefit consumers by lowering their premiums.

The bill changes the retention multiple formula in calculating an insurer's retention, by using exposure from "two years" prior (as opposed to "one year" provided under current law) in calculating the retention factor. This change will permit the FHCF to calculate and provide retention multiples to insurers earlier in the year because the FHCF will no longer have to wait on its more recent exposure data. The retention formula change will enable property insurers to obtain FHCF reinsurance earlier in the year and be able to more accurately assess their need for additional private reinsurance in advance of the upcoming hurricane season.

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[9] To illustrate this issue, when an insurer buys reinsurance from the FHCF, the insurer's rates are set such that the fund's premium will be recovered from its policyholders over the next 12 month period. Therefore, the revenue to cover the FHCF coverage is earned approximately pro rata over the next 12 months (June – May). Under "normal" circumstances, the expense reflected for the FHCF premium is also spread pro rata over the same 12 month period. As a result, the revenue and expense for the purchase of reinsurance from the fund normally results in an approximate "wash" (no income; no loss). For the 2010 transition year, however, a mismatch is automatically created as follows. Because policyholders' rates will not change, the premium revenue is still earned over the same 12 month period, but the expense must be accelerated. The same total annual amount of expense that had previously been divided pro rata into the next 12 separate monthly periods must now be truncated over 7 monthly periods. The amount of expense per month, therefore, must necessarily be greater than if the same expense had been spread over 12 months. Accordingly, the expense, which previously was an approximate match for the monthly revenue, is now substantially greater than the monthly revenue. For every month that the expense is greater than the revenue, it must be recorded as a loss. As a result, the 7 month transition year will show a large loss. Losses, by their very nature, reduce the surplus available to pay claims. By imposing a large loss in the transition year, an insurer's claims paying capacity is substantially reduced and for some companies, the effect could be so great as to impair their solvency.

The legislation caps the FHCF's mandatory layer at $17 billion, unless the FHCF has capacity to pay $17 billion in one year and $17 billion in the subsequent year. If the State Board of Administration determines that there is sufficient claims-paying capacity to provide $17 billion of capacity for the current contract year and an additional $17 billion of capacity for subsequent years, the estimated claims-paying capacity for the particular contract year shall be determined by adding to the $17 billion limit one-half of the fund's estimated claims-paying capacity in excess of $34 billion.

Section 2. Provides that the act shall take effect upon becoming a law.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Fiscal Impact Statement:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

The requirement to publish by January 1st of each year the FHCF's aggregate limit of coverage for the coming hurricane season and the aggregate retention (deductible) will afford residential property insurers greater opportunity to negotiate and structure their private reinsurance programs and better estimate their coverage from the fund. These changes may result in lowering reinsurance costs for insurers which could benefit consumers by lowering their premiums.

Changing the FHCF's contract year will ameliorate accounting difficulties associated with the 2010 transition year provision.

C. Government Sector Impact:

The State Board of Administration (SBA) will be required to publish the FHCF's aggregate coverage and aggregate retention numbers in the Florida Administrative Weekly by January 1st of each year. These costs will be absorbed by the SBA.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

VIII. Additional Information:

A. Committee Substitute – Statement of Substantial Changes:
(Summarizing differences between the Committee Substitute and the prior version of the bill.)

CS by Banking and Insurance on February 16, 2010:

- Technical change to add the word "and" to the term "available and selected."

B. Amendments:

None.